

FINANCIAL SYSTEM INQUIRY

CHAPTER FIVE

GLOBAL COMPETITIVENESS

CHAPTER 5 - GLOBAL COMPETITIVENESS

INTRODUCTION

Australia's financial services industry has been largely domestically oriented. Regulation has prevented Australia's industry from competing strongly against other jurisdictions which are considered financial centres (both within and beyond our time zone).

Despite having an end-to-end financial services industry with scale, sophistication and a record of innovation with delivery of quality outcomes to clients, the industry is neither a major source of export income nor is Australia recognised as a major financial centre with export capability.

Approximately 3.4 per cent of total funds under collective management in Australia are sourced from offshore. This compares unfavourably with regional financial centres in our time zone such as in Singapore with 80 per cent and Hong Kong with 60 per cent sourced offshore.

This chapter considers how competitive Australia's financial system is relative to other financial centres and how we can improve financial regulation with a global focus.

Chapter 5 will:

1. canvass the contribution of financial services makes to the Australian economy and the opportunity to capitalise on our comparative advantages in the Asian region;
2. provide an overview of the policy, regulatory and taxation changes required to enhance Australia's competitiveness in funds management by presenting a stocktake of the "Johnson Review" into Australia as a financial centre (including outlining issues which have emerged over the interceding period); and
3. propose reforming Australia's trust law structures with a new trust law model based on international best practice.

THE CONTRIBUTION OF FINANCIAL SERVICES

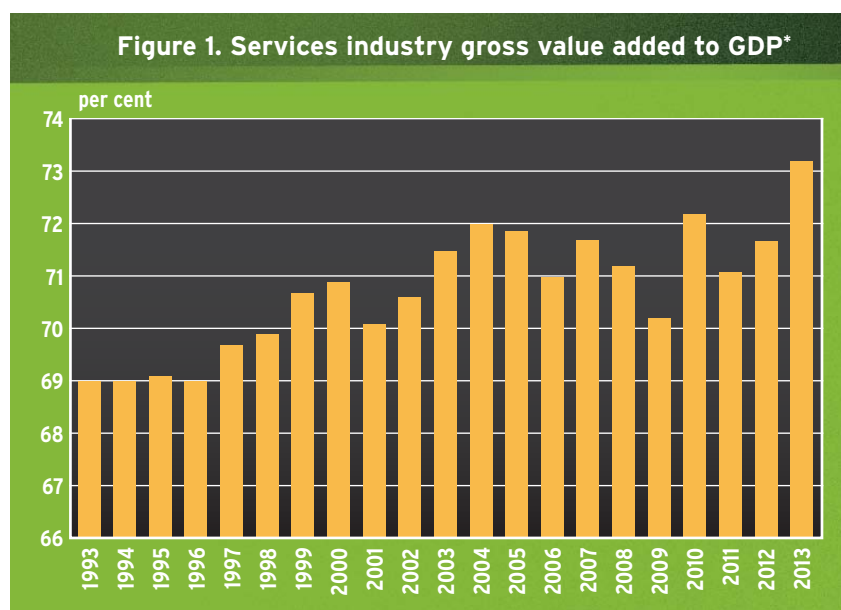
Australia is further transitioning towards a services economy (as measured by employment and gross domestic product). The financial services industry can play a vastly larger role as a contributor to both measures by leveraging our strengths in financial services.

The regulatory competitiveness of financial services affects economic growth in three ways. Firstly, regulation affects the ease with which the financial service sector facilitates growth in other sectors by financing their expansion. Secondly, the regulation of the sector determines the efficiency with which it provides services directly to consumers. Providing financial services to consumers adds directly to GDP growth.

Thirdly, the competitiveness of financial services regulation relative to other countries affects the ability for the industry to generate economic growth through exports.

Financial services is one of a number of industries that grew substantially as the Australian economy transitioned away from manufacturing and agriculture. As the mining boom slows and moves from an investment to production phase, the transition to services industries will continue.

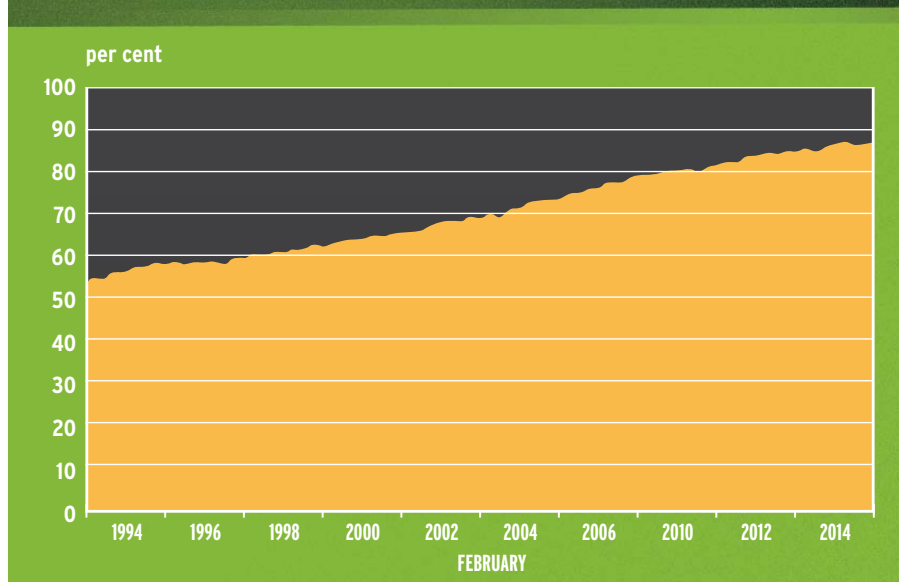
Figure 1 shows contribution to GDP of all services sectors. Services' contribution to GDP has increased from 69 per cent in 1993 to 73.2 per cent in 2013.



Source: ABS 5204 and FSC analysis. *OECD definition of services ie all sectors other than mining, manufacturing and agriculture.

Services share of total employment has also increased over the past two decades. In February 1994, services industries accounted for 54 per cent of total employment. By February 2014, services accounted for 86.7 per cent of total employment.

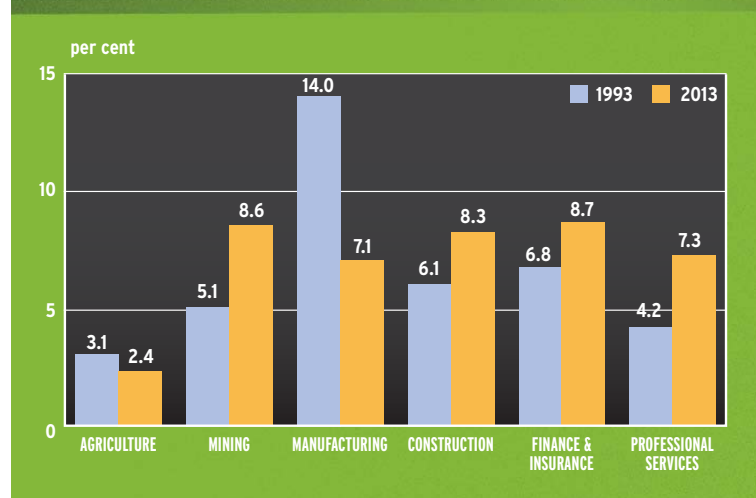
Figure 2. Services industry share of total Australian employment



The trend to higher services contribution to GDP and employment can be expected to continue and the export capacity of this sector needs to be a focus for regulatory efficiency.

Financial services is a facilitator of growth in other sectors but is also a source of economic growth in its own right. Consumers demand financial services in the same way that they demand other goods and services. This demand grows with the wealth of a country and the average age of its population as the need for financial products to manage savings and retirement incomes grows.

Financial services is the largest sector of the Australian economy contributing 8.7 per cent to GDP in 2012-13. The sector's contribution to the Australian economy has grown substantially over the past two decades from 6.8 per cent of GDP. **Figure 3** shows that financial services contribution to GDP has increased substantially relative to most sectors of the Australian economy.

Figure 3. Gross value added to GDP current prices

Source: ABS 5204 and FSC analysis

In some states in Australia, financial services makes a significantly greater contribution to the economy than the national average. For example in NSW and Victoria financial services contributes 12.9 per cent and 10.6 per cent of gross state product respectively.

In addition to the services provided directly to consumers in Australia, providing financial services to other countries in the region is an export industry in its own right. Just as demand for financial services in Australia has grown, so too will demand for financial services in Asia in line with the regions growing wealth and ageing population.

AUSTRALIA'S UNTAPPED COMPARATIVE ADVANTAGE

As a heavily regulated industry, regulation impacts the competitiveness of the financial services industry.

This chapter focuses specifically on issues of regulation impacting global competitiveness. Primarily these are barriers to exporting investment management and trustee services, particularly to the Asian region.

There are many areas of natural competitive advantages for Australian based investment managers. For example, Australian equities, bonds, and property and investment in the infrastructure and resources sectors.

In addition to regulation changes, the Australian investment management industry will also need to develop capabilities where it can realistically compete with the world's best managers which are also in high demand globally. For example, global equities and bonds and possibly Asia Pacific equities and bonds.

In order for these capabilities to be successfully commercialised, we need to ensure that foreign buyers are able to access these products. The 2010 Johnson Report into Australia as a financial centre provided a framework to resolve many of the issues which were making it difficult for foreign investors to access Australian manufactured funds.

THE ASIAN REGION

The Asian region is expected to be a significant driver for growth of the global funds management industry in the coming decades.

This is due economic and demographic changes that are occurring in the region:

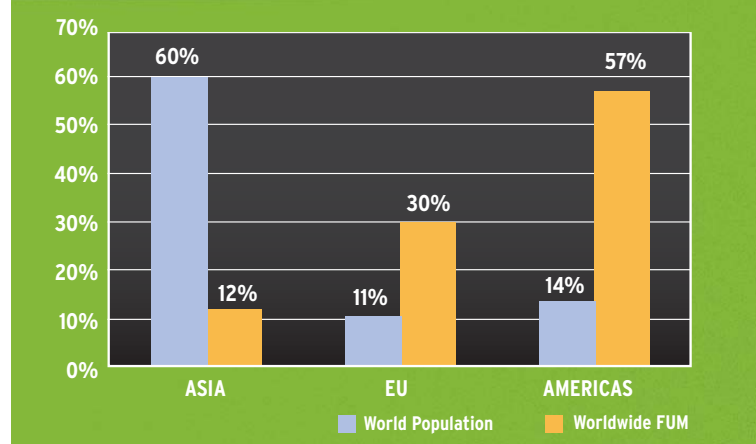
- ❖ Asia's middle class is growing quickly – this will drive demand for funds management as investors look for opportunities to invest and grow wealth;
- ❖ Asia's population is ageing quickly – hence a need for pension and retirement savings products; and
- ❖ many countries in the region do not yet have compulsory pension/superannuation contribution systems for workers – again driving a need for individual savings plans.

The Asia region is currently punching below its weight in terms of share of global funds management activity; there is significant potential for Asia to increase its share.

Funds under management (FUM) in the region is currently USD \$3.410 trillion – this is only 12 per cent of world wide FUM, despite Asia's population sitting at 4.165 billion people or 60 per cent of world's population.

By comparison, the US manages 57 per cent of worldwide FUM but only accounts for 14 per cent of the world's population. Thirty per cent of the world's FUM is managed out of Europe yet it accounts for only 11 per cent of world population. A more relevant measure is % of FUM compared to GDP.

Figure 4. Population and Funds under Management - Asia, Europe and the Americas



Population source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2012 Revision, <http://esa.un.org/unpd/wpp/Excel-Data/population.htm> FUM source: ICI worldwide Mutual Fund Market Data Q1 2013: <http://www.iciglobal.org/iciiglobal/stats/worldwide>

JOHNSON REVIEW STOCKTAKE

In 2010, the Australian Government established an Inquiry to be led by Mark Johnson AO. The *'Australia as a Financial Centre: Building on our strengths'* report ("Johnson Report") handed down in January 2010 concluded that Australia has arguably the most efficient and competitive financial sector in the Asia-Pacific region and that there are significant opportunities to expand our exports to the region from a very low base. The Report stated:

Australia has arguably the most sophisticated and advanced financial sector in the region. However, while Australia is a very open trading economy overall, our exports and imports of financial services as a percentage of GDP are, by international standards, low. The opportunities for leveraging off our financial services skills and expertise, in the region and beyond, are potentially enormous, and have been fully recognised by the Government.

The Johnson Report also found that in order to maximise this opportunity a series of ongoing policy changes were required:

The recommendations are geared towards a wide range of opportunities for greater international engagement: Australian based fund managers managing more offshore sourced funds;

foreign competitors setting up business in Australia or marketing their financial products in Australia; Australian banks doing more transactional business in the region; financial institutions having easier and cheaper access to offshore pools of savings to finance investment; or the Australian based treasury operations of a financial services company managing its offshore assets out of Australia.

While parts of the Johnson Report have been implemented and others are currently being implemented, many remain outstanding. At the same time, competitor economies remain very focused on maintaining their position as leading financial centres in the region. We note the Government remains committed to continue working on implementing the Johnson Report's recommendations. We support the Government's policy to make Australia a more attractive base for financial services activity in the region. In particular, taxation-related incentives such as the development of an investment manager regime and reduction of withholding tax will increase inflows as well as support Australian investment managers in exporting their services through the Asia Region Funds Passport initiative.

Figure 5.

RECOMMENDATION	STATUS
Road-testing of all significant financial services regulatory proposals to ensure necessity, effectiveness and to minimise compliance burden	Ignored
Periodic reviews of regulatory rules & framework to prevent against overregulation	Ignored
Removal of regulatory barriers to Islamic financial products	Ignored - unreleased Board of Taxation Report from 2011
Introduction of Investment Manager Exemption	Botched
Board of Taxation to review allowing a broader range of collective investment vehicles	Ignored - unreleased Board of Taxation Report from December 2011
Removal of state taxes and levies on insurance	Ignored
Removal of withholding tax for foreign raised funds and foreign banks	Botched
Support for offshore banking units	Botched
Establishment of a Financial Centre Taskforce	Botched [established and recommendations consistently ignored]
Coordination between industry and government on skills shortages	Ignored
Government to more actively promote Australia as a financial services centre	Commenced

More needs to be done if Australia is to realise the vision outlined in the Report. We welcome the Government's commitment to completing the outstanding Johnson Report recommendations and suggest this continues to be a policy priority.

The implementation of the Johnson recommendations must be a high priority over the next 12 months.

The following issues were key Johnson recommendations.

ASIA REGION FUNDS PASSPORT

Background

The Asia Region Funds Passport (ARFP) was recommended by the Johnson Review which noted there is a largely untapped opportunity to improve regional market access for Australian managers and for the economy:

Improving market access for Australian fund managers overseas, and at the same time for overseas fund managers in Australia, offers a number of benefits both to financial services businesses and to investors in Australia and overseas. With respect to Australian based fund managers looking to sell their products offshore, improved market access would provide opportunities for lower costs through increased scale; Australian fund managers could also build up greater regional expertise, which they may then be able to export outside the region. These benefits can have flow-on consequences to the wider Australian economy, including lower fees, increased employment of Australian fund managers, fund administrators and support staff, and increased tax revenue.

Johnson further noted that the challenges are considerable:

Differences and duplication in regulatory requirements across countries can add significantly to the difficulties faced by financial services companies selling their products across borders. In some countries, regulatory requirements are so stringent as to make it almost impossible for an Australian fund manager to market a retail managed investment scheme.

Until Johnson, mutual recognition between jurisdictions was seen as the primary vehicle for widening market access for Australian fund

managers and generally reducing trade barriers. However Johnson found that mutual recognition had only limited usage. Instead Johnson stated:

The Asia Region Funds Passport proposal would go beyond a series of bilateral mutual recognition treaties, by providing a multilaterally agreed framework allowing the cross-border marketing of funds amongst member countries...

A multilateral framework would, as far as possible, set out a commonly agreed set of structural requirements (such as arrangements for registration of the fund and licensing of the manager); investment restrictions (such as limitations on leverage or asset classes) and, where feasible, offer conditions (such as prospectus requirements). The Passport would streamline the process of offering a managed fund in any country within the Passport group.

Once operational, the ARFP would permit Australian domiciled investment funds to be sold directly to retail investors in participating jurisdictions and vice versa.

The ARFP is a mechanism to facilitate cross border distribution of managed fund products across the Asia region. Currently, funds are manufactured, distributed and administered within each jurisdiction, with no transferability across borders.

To facilitate transferability of funds management products across jurisdictions an agreed set of regulations need to be developed to govern product issuers and products.

These regulations would not necessarily be identical to the domestic regulations in any of the participating jurisdictions, but would be designed to provide a level of protection for investors that are acceptable to financial regulators in each participating jurisdiction.

The clear preference expressed in the Johnson Review (above) was for a multilateral framework was similar to the successful European Undertaking for the Collective Investment of Transferrable Securities (UCITS) regime.

Competitor regimes

UCITS is a European Union-based regulatory structure for managed funds which has also successfully penetrated our own region. Most of the UCITS products are funds domiciled in Luxembourg and Dublin.

Accordingly to EY:

Taking a step back, the UCITS scheme first adopted in Europe during 1985 is said to be the grandfather and the gold standard for modern cross border fund arrangements. It is seen by the market as the one true fund passport across Europe. The passport enables such funds to be freely marketable across the EU (provided local individual country marketing requirements are met) and can be distributed to both retail and institutional investors.¹

Major Asian financial centres such as Singapore, Hong Kong and Taiwan have become distribution hubs for UCITS funds. Over 5,000 UCITS funds have been registered in the Asian region.

The high penetration of UCITS in Asia means that the:

1. Flow on economic benefit associated with fund domicile accrues to Europe – the services required to support fund domicile include:
 - a. accounting;
 - b. legal;
 - c. technology;
 - d. unit registry; and
 - e. custody.
2. Associated taxation arising from the increased economic activity is largely collected in Europe.

ASEAN Collective Investment Scheme (ASEAN CIS)

Recognition of the benefits associated with funds being domiciled in the region has led to an initiative by ASEAN countries to create a passporting regime to facilitate the cross-border sale of fund products. Following the concept of UCITS and the ARFP, an ASEAN Collective Investment Scheme framework is being established.

On 1 October 2013 the ASEAN Capital Markets Forum announced that the Securities Commission of Malaysia, the Monetary Authority of Singapore and the Securities and Exchange Commission, Thailand signed a Memorandum of Understanding to establish the ASEAN CIS Framework for cross-border offering of collective investment schemes.

The framework will provide mutual recognition of qualifying fund products issued by qualifying fund operators. A detailed framework has been released by the ASEAN Capital Markets Forum. Signatories to the MOU are targeting to implement the Framework in the first half of 2014.

¹ E/Y – Hong Kong / China Mutual Recognition

Hong Kong and China mutual recognition

In January 2013, Hong Kong and China announced plans for the creation of a mutual recognition platform which would permit Hong Kong or Chinese mainland managed funds to be bought and sold in either jurisdiction. Authorised funds of Hong Kong and mainland China are not allowed to be sold directly in each other's market. Under the proposed Mutual Recognition Platform, funds authorised in either Hong Kong or mainland China could obtain authorisation in each other's jurisdiction through a streamlined process.

This arrangement will not be a "fund passport" system like UCITS. Given the limitation of Renminbi (RMB) convertibility and restriction of RMB capital accounts, it is expected that funds authorised in Hong Kong will not automatically gain entry to China and vice versa.

Rather it is anticipated that reputable international managers with a strong track-record in Hong Kong will likely be the first group of managers approved by the mainland Chinese authorities to offer funds in mainland China.

Figure 6. An overview of UCITS, HKCMR, ARFP and ACIS²

	UCITS	HONG KONG AND MAINLAND CHINA MUTUAL RECOGNITION	ASIA REGION FUNDS PASSPORT	ASEAN COLLECTIVE INVESTMENT SCHEME ("CIS") FRAMEWORK
First announcement	First adapted in 1985	January 2013	September 2013	October 2013
Distribution markets	Member states of EU	Hong Kong and mainland China	Singapore, Australia, South Korea and New Zealand	Singapore, Malaysia and Thailand
Target launch	Launched in 1985	No launch date yet	2016	1H 2014
Highlights of conditions	<ul style="list-style-type: none"> Minimal capital requirements of EU1 250,000 Invests in eligible assets includes transferable securities dealt on a regulated market, money market instruments, deposits, close-ended funds, open-ended funds, financial derivatives. No more than 10% assets may be invested in transferable securities or money market instruments that are not listed on a stock exchange or dealt in another regulated market. 	<ul style="list-style-type: none"> SFC authorised funds domiciled in Hong Kong and CSRC authorised funds announced in China. Value of securities issued by any single list issuer may not exceed 10% of its net asset value Value of securities neither listed, quoted nor dealt on a market may not exceed 15% of its net asset value. Prohibition to invest in any real estate. 	<ul style="list-style-type: none"> Not yet disclosed Joint public consultation on regulation and mechanism will be launched in 2014. 	<ul style="list-style-type: none"> Must be licensed or registered by its home regulators. CIS operators must have a track record of at least 5 years. Asset managed by CIS operator and its related companies must have AUM of at least US\$500m globally. Trustee/fund supervisor must be domiciled and regulated in the same jurisdiction as that of the CIS they oversee. CIS operator must maintain shareholders' equity pf at least US\$1m and an incremental of 0.1% for every dollar of AUM that is in excess of US\$500m. Consent to share information between home and host regulators. The assets of a qualifying CIS must be segregated from the custodian's assets and other clients' assets. Qualifying underlying investments may only consist of assets namely transferable securities, money market instruments, deposits, units in other CIS and financial derivatives.

² EY Ibid

It is also likely that the first batches of funds to be sold in mainland China may initially be existing Hong Kong domiciled funds of these managers. Given the competitor regime which Australia is not involved is essential that the ARFP is both expanded to additional countries and the regulatory model is flexible. Both must be achieved if the ARFP is to be a credible competitor to the European and Asian regulatory initiatives and the domestic investment management regulatory structures throughout Asia.

Recent activity

The September 2013 APEC Finance Ministers' meeting in Bali, Indonesia was a key milestone in moving towards liberalised trade of investment funds in the Asian region. The agreement between the governments of Australia, Korea, New Zealand and Singapore to establish a pilot of the ARFP is the beginning of this important project for Australia and our region.

The \$2.2 trillion Australian investment management industry stands to strongly benefit from the Asia Region Funds Passport (ARFP) initiative.

Following the September APEC meeting, the industry has been working within the Asian region to expand the list of APEC economies which are prepared to join the ARFP pilot.

RECOMMENDATION

The FSC recommends that the government continue to play a leadership role in the region in working towards the introduction of an Asia Region Funds Passport. The Asia Region Funds Passport (ARFP) would provide a multilaterally agreed framework allowing the cross border marketing of funds across participating economies in the Asia region.

The ARFP on its own is not a sufficient condition for success in exporting investment management. It needs to be accompanied by investment manufacturing capability which is in demand (which is for industry to develop and therefore not a focus of this submission) tax changes and regulatory changes.

OUTSTANDING JOHNSON TAX CHANGES

We continue to work with Treasury on progressing a number of the tax-related recommendations proposed under Johnson. While there will be an opportunity in the forthcoming Tax White Paper consultation to examine these changes, we wish to emphasise the following key proposals:

1. Investment Manager Regime “(IMR)”

The Johnson Report recommendation that Australia introduce an IMR for non-resident investors is designed to facilitate greater use of Australian investment managers. Fundamentally, the IMR seeks to ensure internationally consistent and unambiguous investment outcomes for non-resident investors who use Australian investment managers through adherence to the following key principles:

- non resident investors should not be subject to Australian tax on non Australian source income;
- non resident investors should be exempt from Australian tax on profits on marketable securities whether dealing on capital or revenue account and whether they use an Australian manager or not; and
- investors should face the same tax outcomes for indirect investment through a collective investment vehicle as for direct investment.

RECOMMENDATION

The FSC recommends the government continue the commitment to deliver a world class Investment Manager Regime (“IMR”) with wide application to a variety of offshore investor types. The regime must strive for equality of taxation outcomes for foreign investors so that investors using an Australian intermediary receive the same treatment as those investing directly.

2. Collective Investment Vehicles

For Australia to improve its competitiveness in financial services, it is necessary to be cognisant of the preferences of international investors. Many foreign investors (even though they may reside in a Double Tax Treaty country) do not come from a common law jurisdiction. Consequently, these investors are not familiar with trusts and often prefer to invest in a Collective Investment Vehicle (CIV) which has either a contractual basis (e.g. an Irish common contractual fund) or is a corporate entity (e.g. a Luxembourg SICAV).

Establishment of alternative flow through vehicles, particularly for non-resident investors is necessary for Australian based fund managers to service these clients from Australia, as opposed to them establishing an off shore CIV for these clients in a competing jurisdiction.

The FSC suggests that the elective approach available to Managed Investment Trusts ("MITs") should not be limited to unit trusts. Instead any legal entity that meets the prescribed prerequisite conditions could be eligible to elect, irrevocably, into the new regime. Once such an entity has elected into the regime the features normally associated with MITs such as transparency, flow through, deemed capital status would apply, regardless of how that type of entity might normally be treated for tax purposes.

By allowing such flexibility, Australian managers would be able to develop products that suited particular overseas jurisdictions. This flexibility will be essential for Australian managers to fully capitalise on the opportunities which will arise through the Asia Region Funds Passport.

Status - no activity has occurred. Government yet to release Board of Tax report.

RECOMMENDATION

The FSC recommends that the Government release the Board of Taxation report and introduce a Collective Investment Vehicle ("CIV") regime comprising a broader range of tax flow-through CIVs to allow Australian based fund managers to compete more effectively internationally.

3. MIT withholding tax

The Johnson Report recommended a reduction of the Managed Investment Trust withholding tax rate. Whilst the rate was reduced to 7.5 per cent, it was subsequently increased to 15 per cent from 1 July 2012. This rate is inconsistent with interest withholding tax rate of 10 per cent and is encouraging investment to be structured as debt instead of equity.

Status - Managed Investment Trust withholding tax rate for fund payments is currently 15 per cent.

RECOMMENDATION

The FSC recommends that the government reduce the Managed Investment Trust withholding tax rate on fund payments from 15 per cent to 10 per cent. This will align the MIT rate to the rate which applies to interest earnings, removing the arbitrage opportunity that was created when the rate was increased to 15% in the 2012-13 Budget and ensuring that Australia remains an attractive destination for foreign capital to be invested.

POST-JOHNSON REVIEW ITEMS

Since the Johnson Report was delivered in 2010, a number of additional tax issues have emerged which are affecting Australia's competitiveness on a global scale. These issues have arisen for a variety of different reasons and range from the adverse impact of global regulation on the Australian market to nuances that have only become apparent as more thought has been given to new policy initiatives. A greater focus on competitiveness should include a resource dedicated to considering issues which emerge as a result of policy changes that intersect with the financial system, whether these changes come from external (foreign) sources or domestic.

A selection of these issues have been included below to demonstrate how the market has been impacted since finalisation of the Johnson Report however more issues will emerge over time as policy settings change.

MULTI-CURRENCY CLASS INVESTMENT FUNDS

Current Australian tax rules make the issuing of multiple currency class investments ineffective because any currency gains or losses must be netted off across classes. The result is that managers wanting to offer different currency denominations must establish a separate fund for each currency class. This is expensive, results in unnecessary duplication and is inconsistent with the features available for funds in jurisdictions such as the United Kingdom and Luxembourg.

Further, the ability to offer multi-currency class investment funds will be necessary for Australian managers to fully capitalise on the opportunities presented by the Asia Region Funds Passport. Without this functionality, managers will be unable to leverage existing Australian or US dollar denominated (Australian domiciled) managed funds into the Passport regime. Instead additional funds will need to be established in each of the relevant currencies (ie, Singapore dollar, South Korean won, New Zealand dollar).

RECOMMENDATION

The FSC recommends that the government amend taxation law to specifically allow multiple fund classes to be operated for different currencies.

MIT CAPITAL ELECTION

When an Australian Managed Investment Trust ("MIT") invests into a European UCITS fund, certain tax treatment options are not effective. The result is that the proceeds of any redemption are treated as dividends for tax purposes rather than as a capital gain.

The range of investments available to Australian investors should not be limited by virtue of a particular consequence which arises as a result of an Australian tax characterisation of the investment vehicle.

Given the importance of appropriate global diversification it is critical that Australian investors have a range of effective global investments available to them.

UCITS are unitised companies and as such the gains on redemption are treated as dividends when there is an increase in value of the UCITS.

RECOMMENDATION

Allow Australian Managed Investment Trusts to elect into capital account treatment for equity-like investment, such as interests in UCITS.

TREATMENT OF FX GAINS/LOSSES

Australian based fund managers investing in overseas assets need to manage the foreign exchange movement associated with their holdings. Typically this is done by taking out FX derivatives in order to ensure that the assets hold their initial FX value. The difficulty with this is that under the Australian tax system profits and losses on such derivatives are treated as assessable / deductible upon realisation (even though the assets to which they relate continue to be held and are typically capital account).

This means that the tax position of such investments diverges from the true economic position. Under the relatively new Taxation of Financial Arrangements ("TOFA") rules it is possible to make a hedging election such that the profits and losses on derivatives are matched against the underlying assets and brought to account at the same time, and in the same manner, that these assets are realised.

RECOMMENDATION

The FSC recommends the government clarify the rules and, if necessary provide an election mechanism for taxpayers to opt into the clarified treatment.

REMOVAL OF INTEREST WITHHOLDING TAX ON COLLATERAL POSTINGS

The Lehman Brothers collapse resulted in greater world-wide focus on counterparty risk for derivative transactions. The international response was to alter the way that derivative positions were managed from one of repricing to one of collateral postings. These are managed through ISDA agreements or central clearing houses. Such arrangements have increased significantly over the last two years.

Under the new collateral arrangements if a financial institution is faced with a potential liability on an open derivative position, it needs to post collateral equal to that liability. Collateral positions for and against are typically netted off in determining the required daily postings but nevertheless significant amounts are now posted and held respectively.

Where a collateral posting is held the posting party is entitled to any interest earned on that deposit. Throughout the world such interest is not subject to withholding tax. An exception is Australia. In Australia interest withholding tax at 10 per cent is potentially applicable if a non-resident posts collateral with an Australian institution. This puts Australia out of step with developments in global financial systems, works against the adoption of a more robust derivatives market and undermines our global competitiveness.

RECOMMENDATION

The FSC recommends that an exemption from interest withholding tax be made in respect of interest earned on collateral deposits pursuant to ISDAs or central clearing house rules.

COMPETITIVENESS AND PROMOTION

GOVERNMENT RESOURCES

The above issues have emerged following the Johnson Report however the dynamic nature of the financial service market means that issues constantly arise that impact on competitiveness.

A government resource dedicated to focussing on competitiveness issues with the authority to generate legislation quickly and effectively has the potential to significantly improve Australia's competitiveness. Such a resource should have a wide remit to deal with tax and regulatory issues affecting the industry.

The Government must commit to post-implementation reviews of measures associated with lifting the level of financial services exports to assess their effectiveness and to benchmark against competitor regimes.

RECOMMENDATION

A dedicated whole-of-government resource be established to promote Australian competitiveness.

PROMOTION

There should be more active and coordinated promotion of financial services through:

- ❖ Twice-yearly Asian delegations to be lead by senior Cabinet Ministers (Prime Minister, Treasurer, Minister for Foreign Affairs) raising the profile of the industry off-shore and seeking improved regulatory outcomes and market access.
- ❖ Greater involvement by financial regulators in promoting the strengths of Australia's regulatory regime and assessing Australia's competitiveness as part of their regulatory obligations. Relevant enabling/governing legislation should be amended to explicitly refer to their role in maintaining and improving Australia's international competitiveness.

- ❖ An annual regional forum be held in Australia involving leading financial services executives, regulators and academics from across the Asia-Pacific. The event would rotate between Sydney and Melbourne and would serve as a platform to promote Australia and facilitate greater regulatory and financial collaboration across the region.

RECOMMENDATION

Increase political-level and regulatory engagement on trade and competitiveness issues.

TRUST LAW IN AUSTRALIA

Research undertaken by the Financial Services Council and the University of Sydney Business School examined the expanded role that trust law can play as an export opportunity for Australia.

In particular, the research considered trustee services which are provided by entities licensed under 5D of the Corporations Act.

Trust law is part of the basic infrastructure that supports Australia's financial services industry. It plays an integral role in the wealth management, corporate/traditional trustee and private banking sectors, and due to the unique use of trusts in Australia, is rapidly becoming as important as company law.

Australian trust law is a mix of centuries old common law and a number of administrative, rather than substantive, legislative regimes, such as Chapters 5C and 5D of the Corporations Act and the State/Territory trustee Acts.

The common law evolved in the family context, to facilitate intergenerational private wealth transfers, which mainly consisted of land holdings. It was not developed with large-scale commercial structures (such as collective investment management) in mind and

was responsive to the policy concerns of the time, many of which do not exist today or are no longer relevant.

The application of anachronistic trust law principles to modern commercial or private trust arrangements can result in undesirable and problematic outcomes for settlors and investors. This directly bears on Australia's ability to service its domestic market and to promote the export of key financial services sectors.

Having conducted a benchmarking study against other common law jurisdictions in our time zone, the Report shows that our system is out-dated by reference to what trusts can do in other jurisdictions that ours cannot.

A review of the trust law practices of other nations, including Singapore, Hong Kong and the UK, as well as traditional offshore financial economies such as the Cayman Islands and British Virgin Islands, indicates that trust law reform is a trend for competing financial centres across the globe.

This trend is responding to changing customer needs and in particular, the desire of individuals and investors to maintain autonomy over their assets, even after death, and to ensure the protection and growth of their assets.

The developing economies of China and India have brought about a surge in high net worth and ultra high net worth individuals and these financial system users, along with an increasingly financially literate populace, are driving the change in customer expectations.

Whereas modern and liberal trusts laws were sometimes associated with offshore economies seeking to promote secrecy and tax avoidance, they are steadfastly becoming an everyday feature of mainland, common law jurisdictions that recognise the economic benefits of endorsing the legitimate purposes of settlor autonomy and asset protection.

Trust law infrastructure is also a critical precursor to other measures, such as the Asia Region Funds Passport which were recommended by the Johnson Report.

Australia is at risk of falling behind its Asia neighbours in respect of trust law reform, and in doing so, forfeiting its position as a major financial centre in the region.

RECOMMENDATION

The Inquiry finds that state-based trust law is not fit for modern commercial and personal trusts.

The Inquiry recommends a federal Alternative Australian Trusts Act be established to operate alongside the general law.

The proposed AATA will provide a substantive federal trust law regime for personal trusts and commercial trust arrangements.

There is a strong precedent for such action. Managed Investment Trusts (MITs) provide a useful example of how Australia has modernised the taxation of trusts for exactly the same reasons. The government announced in 2010 that it was establishing a new regime for MITs.³

In respect of personal trusts, it will offer a choice of law for prospective settlors and will not alter the current arrangements for existing personal trusts.

An AATA could be tailored to meet the needs and demands of both resident and non-resident trust users and could be developed to achieve balanced (domestic/export) policy outcomes for Australia's financial services industry.

³ Assistant Treasurer - "A New System for Managed Investment Trusts" - <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/086.htm&pageID=&min=njsa&Year=&DocType=0>

SUMMARY OF CHAPTER 5 RECOMMENDATIONS:

1. The FSC recommends that the government continue to play a leadership role in the region in working towards the introduction of an Asia Region Funds Passport. The Asia Region Funds Passport (ARFP) would provide a multilaterally agreed framework allowing the cross border marketing of funds across participating economies in the Asia region.
2. The FSC recommends the government continue the commitment to deliver a world class Investment Manager Regime ("IMR") with wide application to a variety of offshore investor types. The regime must strive for equality of taxation outcomes for foreign investors so that investors using an Australian intermediary receive the same treatment as those investing directly.
3. The FSC recommends that the Government release the Board of Taxation report and introduce a Collective Investment Vehicle ("CIV") regime comprising a broader range of tax flow-through CIVs to allow Australian based fund managers to compete more effectively internationally.
4. The FSC recommends that the government reduce the Managed Investment Trust withholding tax rate on fund payments from 15 per cent to 10 per cent. This will align the MIT rate to the rate which applies to interest earnings, removing the arbitrage opportunity that was created when the rate was increased to 15% in the 2012-13 Budget and ensuring that Australia remains an attractive destination for foreign capital to be invested.
5. The FSC recommends that the government amend taxation law to specifically allow multiple fund classes to be operated for different currencies.
6. Allow Australian Managed Investment Trusts to elect into capital account treatment for equity-like investment, such as interests in UCITS.
7. The FSC recommends the government clarify the rules and, if necessary provide an election mechanism for taxpayers to opt into the clarified treatment.

8. The FSC recommends that an exemption from interest withholding tax be made in respect of interest earned on collateral deposits pursuant to ISDAs or central clearing house rules.
9. A dedicated whole-of-government resource be established to promote Australian competitiveness.
10. Increase political-level and regulatory engagement on trade and competitiveness issues.
11. The Inquiry finds that state-based trust law is not fit for modern commercial and personal trusts.
12. The Inquiry recommends a federal Alternative Australian Trusts Act be established to operate alongside the general law.